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Regs.comments@federalreserve.gov

Debit Card Interchange Fees and Routing

Page 7

Networks that process debit card transactions exhibit two main organizational forms, often referred to as three-party and four-party systems.⁶ The so-called four-party system is the model used for most debit card transactions; the four parties are the cardholder, the entity that issued the payment card to the cardholder (the issuer), the merchant, and the merchant's bank (the acquirer or merchant acquirer).⁷ The network coordinates the transmission of information between the issuing and acquiring sides of the market (authorization and clearing) and the interbank monetary transfers (settlement).⁸

⁷ Throughout this proposed rule, the term "bank" often is used to refer to depository institutions.

The footnote identifying the use of the term "bank" as the depository institution attached to the term "merchant's bank" is very misleading. This would give an impression to a reader that the "Merchant's Bank" would be a depository institution when this is not necessarily the case. The Merchant Acquirer many times is not the depository institution.

Page 49

Open versus closed systems. *Debit card networks are closed systems that both issuing and acquiring banks must join in order to accept and make payments. To accept debit card payments, issuing and acquiring banks must decide which debit card networks to join, establish a relationship with those networks, and agree to abide by those networks' rules. In contrast, the check system is an open system in which a merchant simply needs a banking relationship through which it can collect checks in order to be able to accept check payments from its customers. The merchant's bank need not join a network in order to collect a check.*

The check system is also a closed system for similar reasons the Debit Card Network is closed. The Check Payment system is closed to Banks. It is only a Bank that can present checks in a cash letter for payment.

In the Debit Card Network there are rules the issuing and Merchant Acquirer must abide by. In the check payment system there are rules the Payor and Payee Banks must abide

by. These rules for check clearing are the Operating Circulars issued by the Federal Reserve Board. By limiting access to the Check Payment system to Banks the check payment system is able to operate very efficiently as all parties are operating under the same rules. All parties have appropriate reserves with the Federal Reserve to facilitate the check clearing process to assure payment of the cash letter as well as reversal of transactions.

In the Debit Card payment system neither the card issuer nor the acquirer must be a Bank. The debit card issuer could be a non bank issuing a de-coupled card or a prepaid card. The Merchant Acquirer can also be a non bank as is the case with many of the largest merchant acquirers. Therefore just like in the Check Payment System there needs to be a “closed system” to assure efficient operations through adherence to the network rules as well as adequate financial reserves to honor commitments within the settlement processes.

It is recommended that the use of the term “Issuing Bank” be changed to “Issuer” or “Card Issuer” and “Acquiring Bank” be changed to “Acquirer” or “Merchant Acquirer” to avoid a reader from getting the impression that the Issuer and Acquirer must be a “Bank.”

Page 49

***Payment authorization.** Payment authorization is an integral part of a transaction on a debit card network. As part of the payment authorization process a card issuer determines, among other things, whether the card is valid and whether there are sufficient funds to cover the payment. In contrast, payment authorization is not an inherent part of the check acceptance process, and therefore a merchant does not know whether the check will be returned unpaid at the time the merchant accepts the check. However, a merchant that wants to better manage its risks associated with unpaid checks can purchase value-added check verification and guarantee services from various third-party service providers.*

As indicated in the above paragraph the payment authorization is an “**integral**” part of the Debit Card system. In the check payment system there is not a payment authorization. It is appropriately noted that payment authorization is a “**value-added**” service available in the check acceptance process.

Therefore a comparison of the merchant costs and value of the Debit Card settlement process to the merchant costs and value in the check payment system without including the cost and value of payment authorization is flawed. If a comparison is to be made between Debit Card Settlement and check payment system then the “**value**” of the processes need to be equal.

Par Clearing. *In the check system, payments clear at par. When a payee's bank presents a check to the payor's bank, the payor's bank may pay fees to an intermediary for check collections services; however, check payments are cleared and settled for the full face value of the checks. The payee's bank is not required to pay a fee to the payor's bank to receive the settlement for full value of the checks presented. In contrast, in the debit card system, because interchange fees represent fees paid by the merchant-acquiring bank to card issuing bank's the merchant-acquiring bank receives less than the full value of the debit card payments.*

In the check system there is a Payee Bank and a Payor Bank. There are costs associated with check clearing. The Payee bank must deliver the checks to the Payor bank for payment. There is costs to this delivery whether it be through a third party or a direct bank to bank exchange of checks. There are operational costs accepted by both the payee bank as well as the Payor bank. But as noted the banks clear the checks at Par.

It is common in commercial accounts the deposit agreement provides a per item fee for checks deposited. Therefore while the checks may clear at Par and the Payee Bank as well as the merchant receive a Par settlement the net is not at Par as a result of the fees. The account fee structure of the Payee bank typically will include an earnings credit for account balances minimizing the out of pocket fees paid and reduce the realized cost the merchant is paying toward the clearing process. Banks may not charge transaction fees on an identified level of items. But this is based on a portfolio and development of core deposits knowing there may be some loss leader accounts but overall the portfolio of accounts will be accretive to an institution.

The analysis of the cost of Check Payment System seems to have stopped at the Par clearing and did not consider the costs paid or incurred by the Payee's Bank and the Payor's Bank. The report did not identify that these costs are being passed through directly (per item and monthly fees) or indirectly (account balance or relationship services), to the Payee and the Payor.

The analysis of the Check Payment system should include an analysis of the Merchant Checking account and identify the typical fees the merchants are paying for check deposited item fees. The costs for these fees range of \$0.10 to \$0.20.

Additionally the Check Payment System is closed to Banks. The banks developed the check system to settle at Par and the cost and fee structures were developed under this model. The clearing at Par is a reciprocal arrangement.

In the Debit Card system did not develop around a Par Settlement. Therefore the cost and fee structures were not developed based on a Par Settlement. Also in the Debit Card model there is not the same reciprocation. There are significant merchant acquirers that

are non bank providers. These non bank providers are only making presentment for payments and the Card Issuers are incurring network costs to settle the transactions. There is not any reciprocation of the Card Issuers making Par presentments to the non bank providers and incurring comparable costs. Therefore these one directional settlements justify a different model than the check payment system.

Page 51

***Ability to reverse transactions.** In the check system, there is a limited amount of time during which the payor's bank may return a check to the payee's bank. Specifically, a check must be returned by the "midnight deadline," which is midnight of the banking day after the check was presented to the payor's bank for payment. After the midnight deadline passes, a check payor's bank can no longer return the payment through the check payment system, although it may have legal remedies in the event of dispute or financial loss. [Uniform Commercial Code 4-301 and 4-302] In contrast, in debit card system, the time period within which a transaction may be reversed is not limited. Typically, many disputes can be addressed through network chargeback processes without having to rely on legal remedies. These chargebacks and disputes can be handled through the network with procedures that are delineated in network rules.*

This section to a person not familiar with the limitations for reversal of the transactions may get the impression that the Check Payment System is lower risk to the merchant because of the "midnight deadline" compared to the Debit Card System which "is not limited."

The key difference is the reasons for the reversal of the transaction. In the check payment system the merchant deposits the check without any assurances the item may be paid. The "midnight deadline" does not start until the payor's bank receives the item. While the check payment system is very efficient and typically an item will be presented within 2 business days to the payor's bank, there is no assurances that this will be completed in this time window. Items may get misread and improperly routed adding days to the clearing process. Then when the payor's bank makes the decision to return by the "midnight deadline," the item then must route back through to the bank of deposit and notification process to the merchant. This will typically be an additional 2 to 3 business days. Therefore in most reversed transactions through the check payment system notice to the merchant of the return will be 4 to 5 business days. Adding non business days in the process this will then be 4 to 7 calendar days.

The reasons an item may be returned through the check payment system is for practical purposes unlimited. This is because a check is not negotiated until paid. Therefore a maker of a check can place a stop payment on a check for any reason and the check becomes non negotiable. Other reasons can include and are not limited to Non Sufficient Funds, Account Closed and Refer to Maker. The Refer to Maker can be used when there is appearance of fraudulent activity such as improper signature.

Then as noted there are additional remedies in the Uniform Commercial Code of a payor bank which extend beyond the “midnight deadline.”

With the risk of transaction reversal of checks many merchants purchase value added check verification and guarantee services. Some merchants develop internal check acceptance procedures. These procedures may include:

- not accepting checks at all
- require the customer to be from a defined geographical area
- require check number to be greater than a set number in an attempt to establish the tenure of an account. With advancements in technology, check printing software is now available at office supply stores mitigating the value of this mitigation factor
- establish a list of approved check payment clients
- require prepayment of items to allow for the check to clear before delivery of the goods or services
- sending a check for collection rather than through the check payment system

Each of these processes may have direct costs or indirect costs of additional management, loss of sales, payment to third party guarantees, payment for collection services and the loss on returned checks when the risk was not mitigated.

The Debit Card system has specific rules Card Issuers and Merchants agree. The agreement includes the terms and conditions for the reversal of a transaction. The reasons for the reversal of a Debit Card transaction are very limited and therefore, when a merchant adheres to the card present approval process a transaction can not be reversed.

When Debit Card transactions are reversed to the Merchant this is because the Merchant did not adhere to the approval process and accepted a higher risk transaction to consummate a sale. Typically this would be result of a “Card Not Present” transaction and the Merchant entered the card number in manually rather than to read the Magnetic Strip or similar card feature.

Another reason would be the merchant did not deliver a good or service as agreed. The Debit Card Payment System includes these additional consumer protections not afforded in the check payment system. But the satisfactory delivery of a good or service is in the control of the merchant.

Page 52-53

In the definition of allowable costs, the Board proposes to exclude network processing fees (i.e., switch fees) paid by issuers.⁴⁹ Card issuers pay such fees to payment card networks for each transaction processed over those networks. Although these network fees typically are not associated with one specific component of authorization, clearance, or settlement of the transaction, a particular transaction cannot be authorized, cleared and settled through a network unless the issuer pays its network processing fees. The board proposes that network processing fees be excluded from allowable costs, because the Board

*recognizes that if the network processing fees were included in allowable costs, acquires (and by extension, merchants) might be in the position of effectively paying all network fees associated with debit card transactions. That is, an acquirer would pay its own network processing fees directly to the network and would indirectly pay the issuer's network processing fees through the allowable costs included in the interchange fee standard.*⁵⁰

⁴⁹ *These fees do not include processing fees paid by an issuer to a network in its role as processor (i.e., a role equivalent to that of an issuer's third-party processor).*

⁵⁰ *Such an arrangement would be similar to traditional paper-check processing where the payee's bank typically pays all of the processing costs, while the payor's bank typically pays no processing fees. However, this arrangement would be consistent with electronic check collection systems where both the payor's bank and payee's bank generally pay processing fees.*

Page 48

Specifically, EFTA Section 920 requires the Board to (1) consider the functional similarity between electronic debit transactions and checks, which are required to clear at par through the Federal Reserve System and (2) distinguish between the incremental cost of authorization, clearance, and settlement of a particular transaction, which shall be considered, and other costs that are not specific to a particular transaction which will not be considered. Although Section 920 requires only the consideration of these factors, the Board believes that they are indicative of Congressional intent with respect to the implementation of 920, and therefore provide a useful measure for which costs should and should not be included in "the cost incurred . . . with respect to the transaction."

The consideration for standards was to make a comparison of the check payment system to the Debit Card System. As previously identified the Check Payment system checks clear at par and the processing fees are paid by the Payee Bank. But now in the determination of inclusion of the network processing fees, the Board is not including network processing fees as allowable costs for the Debit Card System. This is despite the acknowledgement that the network processing fees must be paid in order for a settlement to be concluded.

In the Board's rationale it is references electronic check collection system which allows a merchant to convert a check to an ACH commonly known as ARC (Account Receivable Collection) or POP (Point of Purchase). These converted checks clear at Par through the ACH system with the Payee Bank then incurring some processing fees. Therefore the rationale is the Payee Bank should therefore also pay the network processing fees in a Debit Card transaction.

The Board does not identify a significant change in the ability to reverse a transaction when a paper check is converted and cleared through the electronic check collection system. As previously discussed a paper check has a “midnight deadline” for reversal of the transaction. Reversal of an ACH Debit falls under Regulation E. The payee has 45 days following knowledge of an ACH debit to dispute the charge. Knowledge of a transaction is considered the date of the monthly statement which includes the transaction. Therefore the dispute can be as long as 75 days following the posting of the transaction. Additionally the merchant converts the check to an ACH and in the event of the maker signature on the check being counterfeit the merchant accepts this risk.

The Board’s charge was to consider the functional similarities between electronic debit transactions and checks. The Board identifies that when a paper check is cleared the Payor Bank does not incur any processing fees. Therefore it would seem the conclusion would be that the Debit Card network processing fees would be included in allowable costs. In a check payment system the Payor Bank pays the processing fees.

The Board elected to compare the Debit Cards to the Electronic Check Payment system in which the Payee Bank incurs some processing fees. But the Board does not detail the differences between Paper and Electronic Check clearing. Nor is there any comparisons to the Payees Bank processing costs for Electronic Checks to the Debit Card network processing fees.

Page 15 of the report identifies the cost for network fees for the card issuer to be \$0.065 and \$0.027 for Signature and PIN Debit transactions respectively.

The cost to the Payee bank for an electronic check through the ACH system is a fractional cent of \$0.003 or less depending on file size and volume discounts. (Federal Reserve Board 2011 Fee Schedule)

Page 54

The Board considered limiting the allowable costs to include only those costs associated with the process of authorizing a debit card transaction, because this option may be viewed as consistent with a comparison of the functional similarity of electronic debit transactions and check transactions. Among the most prominent differences between debit cards and checks is the existence of authorization for a debit card transaction where the deposit account balance is checked at the time of the transaction to ensure that the account has sufficient funds to cover the transaction amount. Clearing and settlement occur for both debit cards and checks, but for checks there is nothing analogous to an interchange fee to reimburse the issuer for the cost of clearing and settling a transaction. However, because the statute instructs the Board to also consider the costs of clearance and settlement, the Board proposes to include those costs. The Board requests comment on whether it should limit allowable costs to include only the costs of authorizing a debit card transaction.

In the check payment system there is not anything analogous to interchange fee paid to the Payor Bank because the items clear at par and the Payee Bank pays the clearing costs. Additionally the payee bank does not provide any guarantee of payment at the time of purchase through the check payment system.

The Debit Card Payment model was designed with an interchange fee, payment guarantee and the Card Issuer paying processing fees. Regulating the amount of the interchange without changing the other components of the model's share of costs and risks is unwarranted.

The authorization of the debit card transaction is comparable to the third party value added check verification and guarantee services. The interchange fee is comparable to the cost to a merchant for these third-party verification and guarantee services.

The allowable costs for Debit Card transactions should include an analysis of check verification and guarantee services. The value of these services is bundled in the Debit Card payment system and should be included in the cost and value of authorizing and payment of a debit card transaction.

Page 57

The Board requests comment on whether it should include fixed costs in the cost measurement, or alternatively, whether costs should be limited to marginal cost of a transaction. If the latter the Board requests comment on how the marginal cost for that transaction should be measured.

Fixed costs of the Debit Card Payment system must be included in the cost measurement. If fixed costs are not included then Card Issuing Bank will be providing the Debit Card services at a loss. This will not be sustainable and banks will either have to suspend the debit card payment system or pass the fixed costs to the consumers via card fees and/or transaction fees. This will reduce consumer use of debit cards and result in a return to Credit Card, Checks and Cash.

Credit Cards have interchange fees paid by the merchants. The end result of limiting merchant fees paid for debit card transactions would result in higher fees paid by the merchant for credit card payments.

It will also drive consumers back to the use of credit cards as a source of payment and the temptation of consumers to abuse of credit card debt.

Check payments increase the merchant's payment risk for returned items or fees for third party verification and guarantee services. Checks also include account fees as well as require staff or third party service to courier the deposit. Where a Debit Card deposit is completed electronically without significant staff time or courier costs.

Payment by cash is not without risk to the merchant. Counterfeit bills, cash shortages and armored car fees are part of the costs of cash payment processing.

Network Exclusivity Provisions

Requiring multiple Debit Card Payment Networks will add complications in the Debit Card system and will increase Card Issuing Bank's operational costs in managing multiple networks. The Card Issuing Bank will increase Vendor Risk and management of the vendors with a second Debit Card Payment Network.

Reconciliation process will be increased and duplicated to reconcile settlements from two sources as compared to one. In event of a dispute or a charge back the transaction will first require research to determine the network used to clear the transaction for the appropriate transaction reversal. Then the management of the items in dispute will be more complex with multiple networks.

As an alternative perhaps the Federal Reserve System should research the development of a Debit Card Payment clearing Network. Then the bank's that are card issuers could utilize the Federal Reserve System as the alternative. This would assure the Merchants would have a payment network alternative that is designed to provide the service at cost. It also would limit the vendor risk of the Card Issuers that are banks since most banks already have a vendor relationship with the Federal Reserve.

If the Federal Reserve is not able to establish a competitive Debit Card Network then the current networks are operating competitively and providing value.

Merchant Choice

In the end the merchant makes a value decision on the various forms of payment. Merchants welcomed the development of the Credit Cards. In its infancy credit cards replaced the merchant accounts providing them liquidity and transferring credit risk to the card issuer.

The value of a debit card transaction to the merchant is the same as a Credit Card. Currently Debit Card transactions are less expensive to the Merchant yet the value to the Merchant is identical. This regulation is designed to only limit the fees in the debit card processing, which is already a lower cost than Credit Cards for the same value.

If the cost of Debit card acceptance is greater than the value received then the merchant should not accept Debit Card payments.

Innovation

Establishing price controls on the debit card industry will stifle innovation of value added services to merchants via debit cards.

Marketing and Consumer Choice

The regulation will likely reduce the relative number of debit card transactions. Marketing of Debit Card use to consumers has already shifted from Debit Cards to Credit Cards. The result of the regulation may not reduce the cost to merchants but actually increase their costs as consumers are enticed to use their Credit Card at a higher cost to the merchant than the Debit Card.

Cordially,

David Rock
Senior Vice President
Chief Operating Officer
Phone (708) 474-1300 x172
Fax (708) 418-2126
Email: drock@fnbiweb.com